and customers of ILEC basic services *absent a demonstrative showing of a cost causative link to basic local exchange or exchange access services for the ILEC plant currently on the books, and which according to USTA and the ILECs, is on the verge of replacement.* USTA and the ILECs do not come remotely close to making the required showing that their investments would have been made on the basis of cost savings or demand-related requirements strictly related to basic local exchange service without consideration of additional revenues from non-basic services. Accordingly, no persuasive claim of special revenue recovery can be made.

C

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)
	)
Access Charge Reform	)
CC Docket No. 96-262	)
	)

Affidavit of Richard B. Lee

1. My name is Richard B. Lee. I am a Vice President of the economic consulting firm of Snavely King Majoros O'Connor & Lee, Inc. I submit this affidavit in response to the Commission's Notice of Proposed Rulemaking ("NPRM") in CC Docket No. 96-262, Access Charge Reform, released December 24, 1996.

2. I prepared the attached report entitled AReply to Local Exchange Carrier Depreciation Reserve Arguments@ on behalf of AT&T. The facts and analyses presented therein are true and correct to the best of my knowledge, information and belief.

The foregoing statements are true and correct to the best of my knowledge, information and belief.

Richard B. Lee

REPLY TO
LOCAL EXCHANGE CARRIER
DEPRECIATION RESERVE ARGUMENTS

Richard B. Lee

Vice President
Snavely King Majoros O'Connor & Lee, Inc.

February 14, 1997

REPLY TO
LOCAL EXCHANGE CARRIER
DEPRECIATION RESERVE ARGUMENTS

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REPLY TO
LOCAL EXCHANGE CARRIER
DEPRECIATION RESERVE ARGUMENTS

I. INTRODUCTION

The Commission's Access Charge NPRM invited comments on the extent to which under-depreciation contributes to the difference between the embedded and forward-looking costs of local exchange access.[1] In its Comments, the United States Telephone Association ("USTA") contends that a significant depreciation reserve deficiency exists.[2] A number of individual local exchange carriers ("LECs") support USTA's contention in their Comments.[3]

This report responds to these contentions. Part II demonstrates that a traditional theoretical reserve calculation based upon the lives currently prescribed by the Commission results in a depreciation reserve surplus, not a deficiency, as of the end of 1996.

In summary, this report concludes that the LECs do not have a reserve deficiency for the provision of telecommunications services.

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[1] Access Charge Reform, CC Docket No. 96-262. FCC 96-488, Notice of Proposed Rulemaking released December 24, 1996 ("Access Change NPRM"), para. 254.

[2] Comments of USTA, p. 74.

[3] See, e.g., Comments of Ameritech, p. 51; GTE, p. 39; U S West, p. 82.

II. THEORETICAL RESERVE CALCULATIONS DO NOT INDICATE A DEPRECIATION RESERVE DEFICIENCY

The USTA alleges that nine price cap LECs have an aggregate depreciation reserve deficiency of $17.9 billion as of the end of 1996.[4] Although this calculation purports to be consistent with the Commission's depreciation study procedures,[5] it does not utilize Commission prescribed lives. Instead, the theoretical reserve calculation for each LEC is based upon lives which are "consistent with its financial reporting."[6] These lives were "reviewed and recommended by Dr. Lawrence Vanston of Technology Futures Inc."[7]

As explained in our Initial Report, neither the lives used by the LECs on their financial books, nor the lives recommended by Technology Futures, Inc. ("TFI"), are appropriate for theoretical reserve calculations.[8]

The lives used for financial accounting purposes are governed by the Generally Accepted Accounting Principle ("GAAP") of "conservatism." As the Commission has found, GAAP is investor-focused, and may not always serve the interest of ratepayers:

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[4] Comments of USTA, Attachment 13. The LECs included are the seven Regional Bell Operating Companies ("RBOCs"), GTE, and the Southern New England Telephone Company ("SNET"). It should be noted that USTA added a $2.3 billion "gross-up" in lieu of actual data for Ameritech.

[5] Id., p. 1.

[6] Id.

[7] Comments of USTA, p. 74.

[8] Comments of AT&T, Appendix C, Analysis of Local Exchange Carrier Depreciation Reserve Levels ("Initial Report"), pp. 6-7 and 9.

> One of the primary purposes of GAAP is to ensure that a company does not present a misleading picture of its financial condition and operating results by, for example, overstating its asset values or overstating its earnings, which would mislead current and potential investors. GAAP is guided by the conservatism principle which holds, for example, that, when alternative expense amounts are acceptable, the alternative having the least favorable effect on net income should be used. Although conservatism is effective in protecting the interest of investors, it may not always serve the interest of ratepayers. Conservatism could be used under GAAP, for example, to justify additional (but, perhaps not "reasonable") depreciation expense by a LEC to avoid its sharing obligation. Thus, GAAP would not effectively limit the opportunity for LECs to manage earnings so as to avoid the sharing zone in the [price cap] basic factor range option. In this instance, GAAP does not offer adequate protection for ratepayers.[9]

Since the GAAP principle of "conservation" creates a bias towards shorter life estimates, the lives used for financial accounting purposes are not appropriate for use in theoretical reserve calculations.

For some LECs, moreover, these lives may be shorter than appropriate due to their plans to replace existing telecommunications networks with integrated telecommunications/video networks. As explained in our Initial Report, the lives recommended by TFI are based upon such a premise.[10] The Commission's rules have long required that the costs associated with the accelerated replacement of facilities for

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[9] Prescription Simplification, Report an Order, FCC 93-452, released October 20, 1993, para. 46.

[10] Initial Report, pp. 6-7.

the benefit of unregulated services be excluded from the regulated accounts.[11] To the extent that LEC financial book lives are shorter due to their plans to provide video programming services, they are inappropriate for use in theoretical reserve calculations.

In addition, these financial book lives may be shorter than appropriate for use in reserve calculations due to LEC plans to replace existing switches and outside plant earlier than otherwise would be the case for normal growth and maintenance needs. As pointed out by Kravtin and Selwyn, "[Our} study concludes that a primary driver of ILEC plant additions and retirements over the past few years was related to and motivated by pursuit of strategic business goals (e.g., additional lines [such as for provision of Centrex services] custom calling) or for entry into new lines of business (e.g., other advanced digital and video services)". [12]

As explained in our Initial Report, the premature retirement of efficient telecommunications technologies could create reserve deficiencies of significant magnitude. For the same reason, premature retirements could lead to an incorrect conclusion that short financial lives are appropriate for use in regulated rates. To the contrary, plant lives for facilities and equipment used to produce regulated services should not be encumbered with the accounting burden imposed by early replacements made for strategic purposes – whether for unregulated or regulated services. To the extent that the LEC financial book lives are shorter due to such plans, they are inappropriate for use in

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[11] Separation of Costs of Regulated Telephone Services from Costs of Nonregulated Activities, CC Docket No. 86-111, Report and Order, FCC 86-564, released February 6, 1987, para. 115.

[12] AT&T Comments, Appendix B, p. vi.

theoretical reserve calculations.

In our Initial Report, we demonstrated that the lives prescribed by the Commission were unbiased and forward-looking.[13] As such, they are appropriate for use in theoretical reserve calculations. As MCI points out, past studies have shown that there is virtually no reserve deficiency when Commission prescribed lives are used in the calculation of the theoretical reserve.[14] Unfortunately, USTA did not provide an update of LEC theoretical reserve studies using Commission prescribed lives.

An estimate of what such studies would reveal can be made, however, using data that USTA did provide. Table 1 of the SPR Report attached to USTA's Comments displays "LEC Estimates of Depreciation Shortfall" by account based upon LEC financial book lives.[15] By adjusting the theoretical reserves shown on this table by the ratio of prescribed lives to financial book lives, one can obtain a reasonable estimate of the LEC theoretical reserve, by account, using Commission prescribed lives as of the end of 1996. As shown on Attachment 2 to this report, at the end of 1996 the LECs had a depreciation reserve surplus, not a deficiency, in each account reviewed.

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[13] Initial Report, pp. 5-6.

[14] Comments of MCI Communications Corporation ("MCI"), p. 72. See, also Comments of the Group of State Consumer Advocates, p. 59.

[15] Comments of USTA, Attachment 15, the Depreciation Shortfall, Strategic Policy Research ("SPR Report"), p. 6.

III. CONCLUSION

This report has demonstrated that LEC contentions that they have a significant depreciation reserve deficiency do not stand up to analysis. As this report has shown, there is no depreciation reserve shortfall.

Calculation of Depreciation Reserve Surplus on a Theoretical Reserve Basis

(As of December 31, 1996)

Account	Financial Life	FCC Life	Theoretical Reserve		Book Reserve	Reserve Surplus
			Financial Basis	FCC Basis		
	a	b	c	d = (a*c)/b	e	f = e-d
Digital ESS	11	16	46.5%	32.0%	35.6%	3.6%
Digital Ckt.	9	11	53.8%	44.0%	51.3%	7.3%
Aerial Copper	16	20	69.6%	55.7%	57.8%	2.1%
Aerial Fiber	20	25	27.1%	21.7%	23.8%	2.1%
UG Copper	16	25	75.4%	48.3%	56.9%	8.6%
UG Fiber	20	25	33.0%	26.4%	27.4%	1.0%
Buried Copper	16	20	60.9%	48.7%	50.5%	1.8%
Buried Fiber	20	25	28.6%	22.9%	25.3%	2.4%

Sources:

Col a = FCC Docket No. 96-262, USTA Comments, Attachment 14 (high end)
Col b = FCC Docket No. 92-296 Orders released 6/28/94 and 5/4/95 (low end)
Col c, e = FCC Docket No. 96-262, USTA Comments, Attachment 15, Table 1

D

February 1997

DEREGULATORY TAKINGS, BREACH OF THE REGULATORY CONTRACT, AND THE TELECOMMUNICATIONS ACT OF 1996

WILLIAM J. BAUMOL* AND THOMAS W. MERRILL**

In a recent article,[1] Gregory Sidak and Daniel Spulber have raised a number of constitutional and economic objections to the introduction of competition into industries formerly served by regulated monopolies. Focusing on both the electricity and local telephone industries, they have argued that the opening of a monopolized market to competition may result in capture by new entrants of the incumbent monopoly's most profitable customers. The result, at least in the short term, may be that the incumbents are left with revenues insufficient to recover the costs of investments they made when it was assumed that they would continue to operate as monopolists. Sidak and Spulber argue that both the Takings Clause of the Fifth Amendment[2] and general principles of contract law[3] impose significant constraints on governmental efforts to deregulate public utility monopolies when the introduction of

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[1] J. Gregory Sidak. and Daniel F. Spulber, Deregulatory Takings and Breach of the Regulatory Contract, 71 N.Y.U.L. Rev. 851 (1996) (hereafter "Sidak and Spulber").

[2] This clause provides: "nor shall private property be taken for public use, without just compensation." U.S. Const. amend. V.

[3] Sidak and Spulber include here principles of promissory estoppel as well as formal contract law. Sidak and Spulber at 931-933.

competition creates such a "stranded investment" problem.

The Sidak and Spulber thesis has moved very rapidly from the pages of academic journals to regulatory tribunals and courtrooms. The appearance of the article coincided with efforts by the Federal Communications Commission (FCC) and state public utility commissions (PUCs) to carry out key provisions of the Telecommunications Act of 1996 designed to bring competition to local telephony. Their article has been relied upon in these proceedings by incumbent local exchange carriers (LECs) to support the proposition that the prices they may charge potential competitors for access to critical bottleneck facilities (like the copper wire loops that connect individual homes and businesses with the local network) must be set at levels high enough to permit them to recover all the revenues they expected to earn from their local exchange network before the coming of competition.

In particular, Sidak and Spulber have been enlisted in support of the proposition that prices for local bottleneck facilities should not be set solely on the basis of forward-looking costs, that is, the costs of replicating or replacing the inputs used to provide discrete network elements or services. Most economists, joined by the FCC and the majority of state PUCs, believe that rational decisions on the pricing of unbundled network elements and access to local networks must be based on forward-looking costs. Sidak and Spulber, in contrast, have argued that once constitutional and regulatory contract considerations are factored in, a vital component of a legitimate pricing method is attention to the historical costs of the assets of the firm whose prices are in question. In so arguing, they are in effect saying that the law requires a fundamental

departure from the principles called for by economic analysis for efficient pricing.

This article comments, both from a legal and an economic viewpoint, on the Sidak and Spulber contentions as they apply to the local competition provisions of the Telecommunications Act. We make two central legal observations. The first is that neither the Takings Clause nor the regulatory contract precludes the use of forward-looking costs in setting prices for network elements or access to local exchange service. Thus, if regulators decide on economic policy grounds to adopt forward-looking prices, no one can claim that this is unconstitutional on its face. Of course, forward-looking pricing -- like any method for establishing prices by regulation -- may be applied in individual cases in a way that introduces an unconstitutional taking. But it cannot be maintained that this method will inevitably or always produce such a result as a matter of law.

The second legal point concerns remedies. Sidak and Spulber maintain in effect that takings and regulatory contract concerns must be addressed in the opening round of the introduction of the Telecommunications Act. The task of regulators and courts, they implicitly assert, is to prevent any taking or breach of contract from ever happening, even if this means compromising on the pricing principles required by economic efficiency. Ordinarily, however, the Takings Clause and the law of contracts are not thought to give rise to what amounts to an injunctive remedy. Instead, they are thought to guarantee only a right to just compensation after a taking or breach occurs. This suggests that the proper remedy is not to interfere with the pricing decisions reached by regulators on economic policy grounds, but to allow those decisions

to be put into effect, and then, after the Act is fully implemented, to determine whether there was any taking of property or breach of contract that remains uncompensated.

Our support for these legal conclusions is reinforced by economic considerations. First, there is good reason to expect the magnitude of the stranded investment problem that will be created by the Telecommunications Act, if any, to be relatively modest. We cannot predict the exact magnitude of the problem. But here it is instructive to contrast the cases of telecommunications and electricity.

- Whereas the introduction of competition into the electric industry is likely to produce enormous redundancy of plant and equipment for incumbent utilities in the short run, such redundancy will be minimal for incumbent LECs. This is because entry into the local telecommunications industry, at least initially, will largely occur through leasing by competing LECs of portions of the facilities owned by incumbent LECs, rather than by competitors' construction of new facilities. As long as the rental prices for existent facilities are compensatory, as appropriately determined forward-looking cost-based prices are, they will remain fully employed and hence cannot be said to represent stranded investment.

- Electric generating plants have basically only one use, and thus can be made fully redundant if competitors emerge with cheaper sources of power. The physical plant used in local telecommunications, in contrast, is readily adaptable to other uses besides placement or receipt of telephone calls. This has already been demonstrated by the introduction of facsimile transmissions and the Internet; many expect cable television

transmission and remote video transmission to be just around the corner. Thus, if incumbent LECs lose part of the local exchange market to competitors, they may nevertheless be able to redeploy their plant to serving emerging markets, thereby further minimizing or preventing redundancy.

- Perhaps most important, the electric utilities will receive no automatic quid pro quo for any losses from stranded investment that they sustain as a result of competitive entry. In contrast, under the Telecommunications Act the LECs are expected to receive extremely valuable compensation in exchange for the advent of local competition, in the form of permission to embark on interexchange (long distance) telecommunications service. The adequacy of this compensation is at least arguably demonstrated by the LECs' own role in pushing for the enactment of the Telecommunications Act, for their attempt to obtain permission to enter these other markets (in full awareness that it was likely to entail the introduction of competition into the local arena) was a key element in the support for the legislation.[4]

In short, there is reason to believe that the local competition introduced by the Telecommunications Act will have minimal if any effects upon the LECs in the form of stranding of investment, and that they can expect to receive a very valuable quid pro quo in exchange for any damage to their legitimate interests. These considerations powerfully reinforce the legal conclusion that there is no legitimate basis to enjoin the use of economically efficient

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[4] See Thomas W. Hazlett, Explaining the Telecommunications Act of 1996: Comment on Thomas G. Krattenmaker, 29 Conn. L. Rev. 217, 223-225 (1996).

pricing principles in the initial stages of execution of the Telecommunications Act.

The second economic consideration involves an evaluation of the serious distortions that uncritical use of the Sidak and Spulber thesis can introduce in the local competition required by the Telecommunications Act. Their approach appears to call for compensation of the LECs for loss of supercompetitive prices for their services. We believe that neither economics nor law entitles any firm to compensation for the loss of monopolistic prices, that is, the loss of earnings or prices made possible only as a result of the current and past monopoly power of the firm in question. The Sidak and Spulber thesis therefore threatens to undermine the most basic purpose of the Telecommunications Act, which is to bring the benefits of competition and competitive pricing to all electronic communications markets. This is yet another reason to permit pricing to be determined on economic principles, and leave questions of just compensation to be resolved after the Act has been fully carried out.

I. The Legal Contentions

In their article, Sidak and Spulber identify two principal legal constraints on the adoption of a competitive access scheme such as that reflected in the Telecommunications Act. The first is based on the Supreme Court's decisions applying the Takings Clause to public utility ratemaking.[5] The Court has held that rates may not be set at "confiscatory" levels, meaning that

[5] Sidak and Spulber at 953-59.

regulated utilities must be given an opportunity to earn a reasonable return on their investment.[6] Sidak and Spulber argue that the introduction of competition into local-exchange service will result in the stranding of a significant portion of their fixed plant investment, and unless the prices charged for access to the LECs' bottleneck facilities are adjusted so as to permit recovery of these stranded costs, the LECs will have been denied the opportunity to earn the fair return on investment that the Takings Clause requires.

The second constraint identified by Sidak and Spulber is that the local competition provisions may constitute a breach of what has been called "the regulatory compact" between the LECs and the government.[7] The idea here is that investors have been induced to provide financing to the LECs for the acquisition of costly assets in reliance on certain critical promises by regulators, including the promise that the LECs will enjoy a monopoly in the provision of local exchange service within their service areas, and the promise that they will be allowed to recover the full cost of all of their past investments that regulators have determined to be prudent. Sidak and Spulber contend that the introduction of competition is inconsistent with these alleged promises. They believe that these abrogations of the regulatory contract should be regarded either as an unconstitutional taking of property rights -- the property rights here being the contractual obligations associated with the regulatory contract -- or simply as a breach of contract.

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[6] Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989); FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944).

[7] Sidak and Spulber at 879-933.

We will not attempt a point-by-point response to each of the arguments and authorities Sidak and Spulber adduce in support of these contentions in their lengthy article. Instead, we will confine our legal discussion to two central propositions. First, neither the Supreme Court's confiscation decisions nor the idea of a regulatory contract support the contention that regulators must consider historical costs in setting prices for unbundled network elements or access to local networks. All that is required is that regulators permit utilities to earn a risk-adjusted competitive return on their investment. Second, the most important issue here is probably one of remedy: should courts in effect enjoin the use of forward-looking prices by the FCC and the state commissions if they think it may cause a taking or breach of contract, or should courts allow forward-looking prices to take effect, and remit the LECs to what amounts to a damages remedy if it turns out, after the Act is fully carried out, that a taking or breach of contract has occurred? We submit that in the pursuit of the far-reaching goals of the Telecommunications Act, compensation after the fact makes far more sense.

A. Established Constitutional Doctrine Does Not Require Recovery of Historical Costs.

It cannot be claimed that the Supreme Court has interpreted the Takings Clause to require that regulators consider the historical costs of investments in setting rates for regulated public utilities. Ever since its 1944 decision in Federal Power Com'n v. Hope Natural Gas Co.,[8] the Court has consistently maintained that regulators are "not bound to the use of any single formula or

[8] 320 U.S. 591(1944).

combination of formulae in determining rates."[9] In effect, the Constitution is neutral as between different rate setting methods, such as the "prudent investment" approach based on historical costs or the "fair value" method based on replacement costs. In its most recent decision, Duquesne Light Co. v. Barasch,[10] the Court reaffirmed this neutrality. Indeed, the Court specifically rejected the suggestion that it adopt the prudent investment approach as the constitutional standard, noting that this would "foreclose a return to some form of the fair value rule just as its practical problems may be diminishing."[11]

What then is the constitutional measure of whether a rate order is confiscatory? In both Hope and Duquesne the Court indicated that the key question is whether the rate of return on investment is "commensurate with returns on investments in other enterprises having corresponding risks."[12] Thus, the constitutional inquiry entails determining (1) the risk of the regulated enterprise; (2) the competitive rate of return available in capital markets on other investments having comparable risks; (3) a projection of the total effect of the rate order on the actual rate of return of the regulated enterprise; and (4) a determination of whether the projected rate of return deviates materially from

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[9] Id. at 602-603. See also FPC v. Texaco, Inc., 417 U.S. 380, 391 (1974); Permian Basin Area Rate Cases, 390 U.S. 747 (1968); Market Street Ry. Co. v. Railroad Comm'n of Cal., 324 U.S. 548, 567 (1945).

[10] 488 U.S. 299 (1989).

[11] Id. at 316 n.10.

[12] Hope Natural Gas, 320 U.S. at 603; see also Duquesne, 488 U.S. at 314 ("One of the elements always relevant to setting the rate under Hope is the return investors expect given the risk of the enterprise"); Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia, 262 U.S. 679, 692-93 (1923) ("A public utility is entitled to such rates as will permit it to earn a return...equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties"). See generally Stephen F. Williams, Fixing the Rate of Return After Duquesne, 8 Yale J. Reg. 159 (1991).

the competitively required rate of return.

It has been suggested, most prominently by Justice Scalia in a concurring opinion in Duquesne,[13] that even if regulators are not required to consider historical costs directly, courts may be required to consider them indirectly insofar as they must decide what "rate base" counts for purposes of computing the projected rate of return. Justice Scalia is right that some conception of the rate base is required for this purpose. But he was wrong to suggest that the benchmark must be a prudent investment or historical cost rate base. As the majority recognized in Duquesne, although the prudent investment method has traditionally looked to historical costs in establishing the rate base, the equally venerable "fair value" method[14] looks to the investment that is "used and useful" to the public in fixing the allowable rate base.[15] The used and useful test does not ask what investment was historically determined to be prudent, but rather what investment is currently being used to provide service to the public. In other words, it is forward- looking rather than backward-looking.

Although reviewing courts may have to adopt some conception of the rate base, there is no reason why they cannot simply use whatever measure of the rate base has been adopted by

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[13] 488 U.S. at 317 (concurring opinion).

[14] The Court's decision in Smyth v. Ames, 169 U.S. 466 (1898), is regarded as having ruled that the fair value method is constitutionally compelled. In at least three subsequent decisions, the Court required that telephone property be valued at current fair value rather than at historical cost for purposes of establishing local telephone rates. West v. Chesapeake & Potomac Tel. Co., 295 U.S. 662, 671-72 (1935); Missouri ex rel. Southwestern Bell Tel Co. v. Public Serv. Comm'n of Mo., 262 U.S. 276, 287-88 (1923); City of Houston v. Southwestern Bell Tel. Co., 259 U.S. 318, 324 (1922).

[15] Duquesne, at 308-09.

regulators. Of course, some methods of defining the rate base entail greater risks for utilities, and switching "back and forth between methodologies" in defining the rate base must enhance risk.[16] But as long as the court remembers that the competitive return must be established by examining investments of comparable risk, and recognizes that risk is in part a function of the chosen rate base (and of the consistency with which the definition of the rate base is applied), legally, the analysis can be carried out using as a benchmark whatever the regulatory jurisdiction itself deems to be the proper rate base.[17]

In short, the confiscation cases provide no basis to declare unconstitutional on its face an access pricing standard that adopts a forward-looking rather than historical standard for cost determination. The only significant constraint imposed by these cases is that a utility must be allowed an opportunity to earn a competitive return on its investment, with competitive return understood to mean the return that would be demanded by investors for investments of comparable risk. Thus, a method based on forward-looking costs, including the current cost of replacement of the physical plant that is used and useful in serving the public, is unquestionably a constitutionally permissible option. One element of risk, of course, is the risk that particular investments will be excluded from the rate base, i.e., will be "stranded" either by operation of law or the forces of

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[16] Id. at 315. See also id. at 310-312 n.7 (discussing the need for a "risk premium" in the allowed rate of return if the jurisdiction adopts an unusual or hybrid definition of the rate base).

[17] For example, suppose a jurisdiction decided to disallow from the rate base all investments over $1 million. Such a method would impose severe inefficiencies on utilities, and would present very large risks. But as long as these risks could be quantified, it would still be possible to determine whether the projected revenues under a rate order would translate into a rate of return that would be constitutionally adequate, given the risks associated with the use of this rate base. Thus, if the under $1 million rate base was determined to be so risky that comparable investments would command a 50% annual return, the question would be whether the allowed revenues would translate into a 50% return or better on this peculiar rate base.

competition. But as long as the rate of return is set at a level that provides adequate compensation for the risk of stranded plant, there is no reason in principle why a system that sets access prices on the basis of forward-looking costs cannot satisfy the confiscation standard.[18]

When we turn to Sidak and Spulber's regulatory contract contention, we also find no basis for the claim that regulators must provide for recovery of historical costs. The critical legal variable that Sidak and Spulber overlook is what the Supreme Court has recently called the "unmistakability doctrine."[19] This doctrine asserts that promises by the government to forbear from certain types of future regulatory action -- in other words, promises of the sort said to be included in the regulatory contract -- will be enforced by the courts only if they are set forth in "unmistakable" language. Viewed through this lens, we find that the scope of the regulatory compact that would be regarded as enforceable by courts is considerably less sweeping than urged by Sidak and Spulber.

In testimony filed after the publication of their article, Sidak and Spulber have argued that the Supreme Court's recent decision in United States v. Winstar, [20] which discusses the

[18] The question of what rate of return should be adopted in setting prices for unbundled network elements has been left to the determination of individual state PUCs. See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, Federal Communications Commission CC Dkt. Nos. 96-98, 95-185, 11 F.C.C. Rcd 15499 (1996) (hereinafter First Report and Order) at ¶ 702.

[19] See United States v. Winstar Corp., 116 S.Ct. 2432, 2453 (1996); United States v. Cherokee Nation of Okla., 480 U.S. 700, 707 (1987); Bowen v. Public Agencies Opposed to Social Security Entrapment, 477 U.S. 41, 52 (1986). The doctrine is of considerable antiquity, and can be traced in this country to the decision in Charles River Bridge v. Warren Bridge, 11 Pet. 420 (1837).

[20] 116 S.Ct. 2432 (1996).